NOT TO BE PUBLISHED IN OFFICIAL REPORTS

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

FIRST APPELLATE DISTRICT

DIVISION ONE

TOSHIBA AMERICA MEDICAL SYSTEMS, INC.,

Plaintiff and Appellant,

v.

OEC MEDICAL SYSTEMS, INC.,

Defendant and Respondent.

A067742

(San Francisco County Super. Ct. No. 961597)

A corporation bought a business division of another corporation and agreed to indemnify the seller from certain liabilities relating to the business operations assumed. The parties agreed that any controversy about the purchase contract would be settled by arbitration. A controversy arose when customers sued both corporations for alleged inadequacies of service and goods and stated claims for breach of contract and fraud, among other wrongs, and sought compensatory and punitive damages. Arbitrators decided that the buyer had to fully indemnify the seller on the customer lawsuits and rejected the buyer's argument that indemnification for intentional misconduct, fraud, and punitive damages was beyond the contractual indemnification provision or was precluded by a public policy against shielding intentional wrongdoers. The arbitrators' award in favor of the seller was confirmed by the trial court, over the buyer's effort to have the award vacated, and this appeal followed. We affirm the confirmation order.

STATEMENT OF FACTS

In 1989, appellant Toshiba America Medical Systems, Inc. (Toshiba) purchased substantially all of the business and

assets of the magnetic resonance imaging (MRI) division of respondent Diasonics, Inc. (Diasonics, now known as OEC Medical Systems, Inc.), which manufactured, serviced, and sold MRI medical devices used to examine soft tissue. The purchase agreement with its attachments is a detailed and voluminous document of 171 pages. Under the agreement, Toshiba paid Diasonics $167.5 million and assumed certain liabilities in consideration for receipt of the MRI division as a going concern. Toshiba also agreed to indemnify Diasonics from any damages and costs arising from those liabilities.

In 1992, several MRI customers filed lawsuits against Toshiba and Diasonics in various jurisdictions claiming they received inadequate service and goods that amounted to breach of contract and fraud, among other wrongs. Diasonics tendered the defense of these underlying actions to Toshiba. Toshiba denied an obligation to defend or indemnify Diasonics, at least to the extent that the underlying actions involved intentional misconduct or fraud claims, or sought punitive damages.

In September 1992, Diasonics filed a petition with the American Arbitration Association (AAA) to determine the scope of Toshiba's indemnity obligations. The 1989 purchase agreement provided that its terms would be governed by California law and that any controversy relating to the agreement would be settled by arbitration in accordance with AAA rules and California law. The parties agreed to a three arbitrator panel; Toshiba and Diasonics each selected an arbitrator and the third, neutral arbitrator was mutually selected to chair the panel. The arbitrators were empowered to determine the manner of conducting the arbitration.

The parties submitted their dispute to the panel in the spring of 1993 by the presentation of documentary evidence, legal memoranda, and oral argument. Diasonics states that five volumes of documents and fourteen briefs were submitted. The neutral arbitrator distributed to the other panel members a draft decision in Diasonics favor to which the Toshiba-appointed arbitrator, Joseph Stallings, objected. Stallings

disagreed with the decision's conclusion, and also objected to the lack of substantive deliberations before its circulation. The arbitrators then conferred, but Stallings found the discussion futile because he felt a final decision had already been made.

A majority of the arbitrators (the neutral arbitrator and the Diasonics-appointed arbitrator) issued an interim decision in April 1993, from which Stallings dissented. This decision was to be the first interim decision, as the arbitrators requested further party submissions on other issues which were resolved in a second interim decision issued in December 1993. Stallings also dissented from that December decision favorable to Diasonics, after having participated in the second round of proceedings which included a panel conference. Stallings resigned soon after issuance of the second interim decision, upon protests that the neutral arbitrator did not permit meaningful discussions in the arbitral process.

Toshiba appointed a replacement arbitrator who reiterated Stallings' claim that the arbitration had proceeded without meaningful discussions and the replacement proposed beginning anew, "with deliberations to begin as if nothing had heretofore transpired." The other arbitrators apparently rejected this proposal, and issued their award incorporating the two interim decisions in March 1994. Toshiba filed a petition in superior court to vacate the arbitrators' award and Diasonics filed a cross-petition to confirm the award. The arbitrators' award was confirmed on October 7, 1994, and this appeal followed.

DISCUSSION

California Law Governs our Review of the Arbitrators' Award

Toshiba's challenge to the arbitrators' award begins with the preliminary argument that federal law, not California law, governs our review of the award. Toshiba notes that the Federal Arbitration Act (FAA) (9 U.S.C. § 1 et seq.) applies to arbitration provisions in contracts involving interstate commerce and preempts any conflicting state law. (*Allied-Bruce*

Terminix Companies v. Dobson (1995) __ U.S. __ [115 S.Ct. 834, 839-843].) However, the parties here agreed that both the terms of the contract and the arbitration of any controversy under the contract would be governed by California law. The FAA does not prevent contracting parties from agreeing to abide by state rules of arbitration. (*Volt Info. Sciences v. Leland Stanford Jr. U.* (1989) 489 U.S. 468, 479.) In recognition of this freedom of contract, California courts have respected the parties' recognition of this freedom of contract, California courts have respected the parties' choice of state law in the arbitration of contracts involving interstate commerce. (*Engalla v. Permanente Medical Group, Inc.* (1995) 37 Cal.App.4th 497, 519-521; *Pacific Gas & Electric Co. v. Superior Court* (1993) 15 Cal.App.4th 576, 587, fn. 3.)

Toshiba attempts to limit the rule of *Volt Info. Sciences,* claiming that the case permits parties to choose state procedural rules of arbitration but that federal law always governs substantive issues in the arbitration of contracts involving interstate commerce, regardless of the parties' choice of law. Toshiba's proposed distinction between arbitration procedure and arbitration substance is slippery to grasp. But assuming such a distinction can be maintained, it is a distinction without significance. Whether termed procedural rules or substantive issues, the contours of the arbitration process should be within the crafting power of the parties who have chosen arbitration to resolve their conflicts. Arbitration "is a matter of consent, not coercion, and parties are generally free to structure their arbitration agreements as they see fit." (*Volt Info. Sciences v. Leland Stanford Jr. U., supra,* 489 U.S. at pp. 478-479.) Certainly, contracting parties may limit the issues that they will arbitrate. *(Ibid.)* We see no reason why contracting parties may not also specify the law to be applied to the issues that they will arbitrate, at least so long as the chosen law does not undermine the FAA's policy ensuring the enforceability of arbitration agreements. Here, the parties' choice of California law to govern the arbitration of controversies arising under the purchase agreement does not offend any federal policy. The parties' choice must be respected.

Review of Arbitration Awards is Limited

Under California law, the review of a private arbitration award is narrow and deferential. "[A]n arbitrator's decision is not generally reviewable for errors of fact or law, whether or not such error appears on the face of the award and causes substantial injustice to the parties." *(Moncharsh v. Heily & Blase* (1992) 3 Cal.4th 1, 6.) A court's power to correct or vacate an arbitration award is limited to those statutory grounds specified in Code of Civil Procedure sections 1286.2 and 1286.6 which generally authorize the court's involvement to protect parties from an abuse of the arbitral process, such as where arbitrators have "exceeded their powers." *(Moncharsh, supra,* at pp. 26-28; Code Civ. Proc., § 1286.2, subd. (d).) Judicial intervention may also be appropriate if the arbitration award enforces a contract which is illegal in its entirety or, in exceptional circumstances, where a portion of the contract is clearly illegal. But "[a]bsent a clear expression of illegality or public policy undermining [the] strong presumption in favor of private arbitration, an arbitral award should ordinarily stand immune from judicial scrutiny." *(Moncharsh, supra,* at p. 32.)

The Arbitrators Did Not Exceed Their Powers

Toshiba contends that the arbitration award must be vacated because the arbitrators "exceeded their powers" in interpreting the purchase agreement. (Code Civ. Proc., § 1286.2, subd. (d).) Toshiba's chief complaint arises from the arbitrators' interpretation of the assumption of liabilities provisions. In the purchase contract, Toshiba agreed to assume certain liabilities on the closing date pursuant to an assumption agreement of specified terms. The later executed assumption agreement precisely reflects those terms and provides, in relevant part, as follows:

> "Purchaser [Toshiba] hereby assumes, and agrees to pay and discharge in due course, all debts, liabilities, contracts, obligations and agreements of, and claims against, Seller [Diasonics] relating to the [MRI] Division and the Subsidiaries (whether or not expressly identified on the Closing Pro Forma

> Balance Sheet), whether matured or unmatured, liquidated or unliquidated, fixed or contingent, or known or unknown, whether arising out of occurrences prior to the date hereof, or arising at or after the date hereof in the ordinary course of business ...."

The assumed liabilities were further defined to include several enumerated categories of liabilities and also defined to exclude other categories, none of which encompass the particular liabilities Diasonics sought to have indemnified here. It is the general assumption of liabilities provision which the arbitrators interpreted.

The arbitrators concluded, in their first interim decision, that Toshiba's broad assumption of liabilities plainly included the fraud claims in the underlying actions for which Diasonics sought indemnity. Toshiba argued in arbitration, and argues on appeal, that indemnity is limited to liabilities arising in the "ordinary course of business" and that fraud is not such a liability. The arbitrators rejected that interpretation, finding that the qualification "in the ordinary course of business" applies only to occurrences "arising at or after the date hereof," and the arbitrators understood that date to be August 23, 1989, the date of the purchase contract.

In essence, the arbitrators decided that Toshiba agreed to broadly indemnify Diasonics for liabilities arising before the purchase date, but limited its indemnification for liabilities arising between the purchase and closing dates to those liabilities related to the "ordinary course of business" to guard against a detrimental change in Diasonics' conduct of the business at a time when it had a signed purchase agreement in hand and was just maintaining the business until Toshiba took over the operations. Since the arbitrators decided that the "ordinary course of business" limitation had only a narrow temporal application irrelevant to the underlying actions, the arbitrators found it unnecessary to decide whether the fraud claims arose in the "ordinary course of business."

Toshiba disputes the arbitrators contractual interpretation, arguing that the "ordinary course of business" qualification

relates to all liabilities. In other words, Toshiba argues that an error of law occurred in the arbitrators' interpretation of the parties' contract. "[A]rbitrators do not exceed their powers merely by erroneously deciding a contested issue of law or fact." *(Advanced Micro Devices, Inc. v. Intel Corp.* (1994) 9 Cal.4th 362, 366, citing *Moncharsh v. Heily & Blase, supra,* 3 Cal.4th at p. 28.) However, it remains an open question as to when, if ever, an erroneous interpretation of a contract constitutes an action in excess of arbitral power. Division Five of this district has endorsed a standard predating *Moncharsh* and declared that " 'a decision exceeds the arbitrator's powers only if it is so utterly irrational that it amounts to an arbitrary remaking of the contract between the parties.' " *(Blue Cross of California v. Jones* (1993) 19 Cal.App.4th 220, 228; accord, *Pacific Gas & Electric Co. v. Superior Court, supra,* 15 Cal.App.4th at pp. 592-593.) But Division Three of this district has questioned the continuing vitality of the "completely irrational" standard. *(Hall v. Superior Court* (1993) 18 Cal.App.4th 427, 434-435.)

Our Supreme Court is cognizant of the controversy but has not yet had occasion to determine "whether an arbitrator's interpretation of a contract is subject to review for 'irrationality' or 'arbitrariness.' " *(Advanced Micro Devices, Inc. v. Intel Corp., supra,* 9 Cal.4th at p. 377, fn. 10.) The court has, however, delineated a standard for determining whether an arbitrator has exceeded his or her powers in awarding relief for a breach of contract: the remedy "must bear some rational relationship to the contract and the breach." *(Id.* at p. 381.) "The award will be upheld so long as it was even arguably based on the contract; it may be vacated only if the reviewing court is *compelled* to infer the award was based on an extrinsic source." *(Ibid.)* In fashioning this standard, the court was aided by federal cases applying the "essence" test which holds that an arbitrator's award is legitimate so long as it draws its essence from the contract. *(Id.* at pp. 377-378.)

The "completely irrational" standard has its origin in the "essence" test, and both seem animated by the recognition

that an arbitrator's powers derive from the arbitration agreement and are exceeded if he or she operates wholly outside its framework. *(Advanced Micro Devices, Inc. v. Intel Corp., supra,* at pp. 375, 377, fn. 11.) The close relation between the "completely irrational" standard and the "essence" test which informed the court's formulation of its rule for the review of an arbitrator's breach of contract remedy lends support to Toshiba's argument that the "completely irrational" standard has not lost all value after *Moncharsh.* The extent of that value, of course, is unclear, and it is far from certain that the "completely irrational" standard is a worthy guide for assessing whether an arbitrator's contract interpretation is in excess of his or her powers. However, even if we accept this standard, the award here remains inviolate.

" '[A] decision exceeds the arbitrator's powers only if it is so utterly irrational that it amounts to an arbitrary remaking of the contract between the parties.' [Citations.] 'The mere fact that a different construction could have been accorded the provisions concerned and a different conclusion reached does not mean that the arbitrators so misread those provisions as to empower a court to set aside the award.' " (*Blue Cross of California v. Jones, supra,* 19 Cal.App.4th at p. 228.) "[A]rbitrators do not exceed their power by erroneously interpreting a contract. A valid claim that arbitrators have exceeded their power exists only where the arbitrators' interpretation or application of a contract is completely outside its scope." *(Id.* at p. 229.) Here, the arbitrators interpreted the reach of the qualifying clause "ordinary course of business" and found that it did not modify the entire indemnification provision defining liabilities, but only the last clause relating to liabilities arising after the date of the purchase agreement. Toshiba's effort to paint this workaday resolution of contract terms as an irrational "rewriting" of the contract is futile.[1] "Where, as here, the arbitrator's reading and

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[1] Similarly, Toshiba's claim that the arbitrators misinterpreted its assumption of liability for a bank guaranty does not establish a "completely irrational" decision.

application of the contract is clearly within the range of ambiguity, i.e., within the ordinary bounds of semantic permissibility, there can be no tenable claim that the contract has been arbitrarily remade. "*(Pacific Gas & Electric Co. v. Superior Court, supra,* 15 Cal.App.4th at p. 594.)

The Arbitration Award Does Not Offend Public Policy

Toshiba argues that the arbitration award must be vacated because it contravenes public policy which forbids indemnity for fraud, intentional misconduct and punitive damages. The arbitrators themselves considered public policy concerns. They concluded that nothing forbid the indemnification of fraud and intentional misconduct occurring before the date of the purchase contract, noting that Civil Code section 2774 provides that; "[a]n agreement to indemnify a person against an act already done, is valid, even though the act was known to be wrongful, unless it was a felony." The arbitrators found "no showing by Toshiba that any of the underlying actions involved conduct by Diasonics that constituted a felony." The arbitrators also considered the question of whether punitive damages could be contractually indemnified. The arbitrators' decision, rendered in the affirmative, was based on factual determinations concerning the arm's length negotiations by these sophisticated parties and legal conclusions about the nature and goals of punitive damages and corporate accountability.

Toshiba bears a heavy burden in claiming that the arbitrators' decision violates public policy. Our Supreme Court has grudgingly acknowledged that there may be some limited and exceptional circumstances justifying judicial review of an arbitrator's decision when a party claims illegality affects only a portion of the underlying contract. Such cases would include those in which granting finality to an arbitrator's decision would be inconsistent with the protection of a party's statutory rights. [Citation.] [¶] Without an explicit legislative expression of public policy, however, courts should be

reluctant to invalidate an arbitrator's award on this ground." *(Moncharsh v. Heily & Blase, supra,* 3 Cal.4th at p. 32.)

We are properly reluctant. This situation is not the rare case where "according finality to the arbitrator's decision would be incompatible with the protection of a statutory right." *(Moncharsh v. Heily & Blase, supra* 3 Cal.4th at p. 33.) Nor do we discern a clear expression of public policy contradicting the arbitrators' decision. No California law directly addresses the question of whether a corporate successor may contractually indemnify its predecessor for punitive damages relating to the predecessor's past conduct of the business operations it assumes. Nor is it clear that Civil Code section 2774's proscription against indemnifying felonies applies -- as Toshiba claims -- to any "felonious conduct," including large-scale fraud, even if no criminal charges are ever filed. Toshiba has simply failed to establish that the arbitrators' decision harms the public interest.

There Was No Arbitrator Misconduct

An arbitration award will be vacated where "[t]he rights of the party were substantially prejudiced by misconduct of a neutral arbitrator." (Code Civ. Proc., § 1286.2, subd. (c).) Toshiba claims the neutral arbitrator, Peter Anderson, engaged in misconduct by refusing to confer and deliberate with Stallings, the Toshiba appointed arbitrator, and by having communications with Diasonics' counsel and the Diasonics appointed arbitrator in Stallings' absence. Toshiba has grossly mischaracterized the arbitration proceedings.

The parties chose a three arbitrator panel. Each party appointed one arbitrator and the third panel member was mutually selected as a neutral arbitrator to chair the proceedings. All arbitrators were experienced attorneys and they were expressly empowered to determine the manner of conducting the arbitration. Stallings made no objection to the arbitration procedures until Anderson issued the draft of his first interim decision in favor of Diasonics. It was at that time that Stallings complained that Anderson did not permit meaningful deliberations among all arbitrators before reaching his

conclusions. Anderson explained that he issued a draft decision, rather than convene the panel for discussions, because the parties' positions had already been exhaustively presented in hearings before the panel and there was no need to have the party-appointed arbitrators reiterate the same oral arguments. The procedure of submitting a draft decision to the party-appointed arbitrators avoided repetition of argumentation while permitting them an opportunity to participate in the decision-making process by pointing out any arguments that had been "overlooked or misunderstood." Anderson had told the party-appointed arbitrators that he was considering proceeding in this manner and was surprised that Stallings later decried the procedure. In deference to Stallings' concerns, a different procedure was adopted in the second round of proceedings and a panel conference was held before issuance of a draft decision. Our review of the record convinces us that the neutral arbitrator conducted the arbitration proceedings fairly and honestly.

Toshiba's claim that Anderson engaged in "inexcusable ex parte communication" with Diasonics' counsel and Diasonics' appointed arbitrator is equally meritless. The communications were minor and wholly innocent. Anderson's communication with Diasonics' counsel occurred when counsel called Anderson's office to inquire about the anticipated release of the first interim decision and Anderson answered the telephone. Anderson told Diasonics' counsel that the decision's release would be delayed a few days and the conversation ended. Anderson disclosed that communication to the AAA and it found no impropriety. The other challenged ex parte communication was a telephone call to Anderson from the Diasonics appointed arbitrator to ask if the terms of the recently released draft interim decision could be revealed to Diasonics. During neither of these communications was the merits of the case discussed or even mentioned. Toshiba's claim of arbitrator misconduct is absurd, and appears to be no more than an attempt to manufacture grounds to vacate an unfavorable arbitration award at the expense of an arbitrator's reputation.

DISPOSITION

The order confirming the arbitration award is affirmed.

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Strankman, P.J.

We concur:

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Stein, J.

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Dossee, J.